

KRAEMER, SCHWAB & CO. AG

Investment Management

FINANCIAL REVIEW 2007 AND OUTLOOK 2008

2007 was (after 4 very rewarding years for investors) a sobering disappointment, as the credit bubble fueled by persistently low interest rates started to burst. The optimism at the beginning started to fade in the middle of the year when one financial company after the other began to report losses of increasing magnitude in the US sub prime mortgage market. A recently developed derivative, CDO or Collateralized Debt Obligation, bears the main blame, but in reality many different players have contributed to the formation of the bubble. CDOs were originally developed on the premise that a package of mortgages originating in different regional real estate markets would reduce overall risk since local markets are not highly correlated. Rating agencies like Standard & Poor's and Moody's afforded them high quality ratings based on the wide diversification, although the pricing and rating of these instruments were based on complicated assumptions not supported by much historic data. We suspect that the large fees may have clouded the judgment of the rating agencies. In the ongoing real estate boom, originators saw a huge market opportunity. Volumes grew enormously, but the documentation was done more and more carelessly and sloppily and, in some cases they were even falsified to get funds unlawfully. The assembling, repackaging and distribution was so profitable for a while that out of greed the execution was done without any sense of decency and responsibility in a corrupt way, especially because the practice of securitization created a huge agency problem. While in the old world lenders would carefully assess the creditworthiness of borrowers, in the dream world of securitization originators would quickly resell their loans to the market, retaining origination fees but transferring to third parties ownership of the loans and with it credit risk. A practical, useful product was thus perverted into a gigantic tool of wealth destruction. In the ensuing bust the list of those suffering the biggest losses is nearly identical with the list of the biggest banks and investment houses in the world. Very few have escaped unscathed. One gets the impression that these financial institutions play with their funds, for a while with a certain restraint, but periodically about every five years they throw off all inhibitions and gamble unscrupulously in casino style (Charles Prince, CEO of Citigroup until his resignation end 2007, just a few weeks before the explosion of the crisis declared that as long as the music would play, his bank would continue to dance in the CDO market)

Luckily we haven't invested in CDOs, but we own several banks, which have suffered losses in this crisis. The spreading tension is also harming companies, which are not directly involved in CDOs. Obtaining any credits has become much more difficult, because a general distrust has replaced the former carelessness. A very restrictive handling of future credits will hurt economic growth, a recession and a time of negative growth in the economy is now quite possible. This is for the public and most investors a frightening, even terrifying scenario, and central banks and governments do all in their power to avoid it.

We look at it differently, since we are value investors. The best time to purchase extraordinary values cheaply is before or during a recession, when everybody thinks that the downturn will not end soon and stock prices will keep going down. At these points in the cycle the future is admittedly unclear and orientation is difficult. Doubts overwhelm the masses. But it is a period, which savvy investors like Buffett love. At his age of 78 years, he said recently in an interview, he hopes to witness still two recessions. His actions show why. The cash pile in his company has grown in recent years, while he was only a hesitant acquirer, to over \$45 billion. Now he has turned more acquisitive when the public mood has started to plunge and turned pessimistic. Over the last few days of the year he has bought two companies for over \$5 billion, not even stopping over Christmas. From his conduct we should learn: never let a lousy mood, a bleak outlook in the market influence you to become pessimistic. Weigh objectively positive and negative factors, then determine long term values and if prices are decidedly below this level, buy. Never mind, if prices continue to fall, just buy more. Don't try to predict the timing of the next upturn, this is impossible anyway; just wait confidently until it happens. It is pleasant and helpful if your investments in the meantime throw off nice dividends. Capitalistic markets from time to time tend to become exuberant and need a recession to correct and eliminate mistakes and excesses and to reestablish reason and sound allocation of capital.

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Investors may wonder, to which degree and for how long banks and financial institutions, which seem to be in the epicenter of the present storm, will suffer. How long will it take them to recover their huge losses? At the moment, a precise answer is impossible. A few will probably never fully recover. But a majority has been downgraded to such an extent that their valuation includes further losses but often does not reflect the potential and profitability of their attractive parts like credit business, private banking and fund management and not to mention the high dividend yield. History has shown that these businesses are highly profitable. Unfortunately their managements are periodically prone to recklessness and hubris, which, combined with leverage, can lead to catastrophic results. Despite these negative characteristics we are positive for this beaten down sector, with some reservations and at least for the next few years. We favor banks like HSBC, Royal Bank of Scotland, UBS, Hypo Real Estate and insurance companies like Allianz, Munich Re, Hannover Re, Swiss Re and AIG.

Pharmaceutical and medical technology companies form another neglected and avoided group. They have been very popular along with high tech companies in the dot.com boom when few, but highly profitable blockbuster drugs supported high profitability. Lately some high profile drugs have shown side effects which led to product liability problems. The FDA is more restrictive in giving out licenses. The industry has to switch to an operating mode with fewer blockbusters but many more drugs with a smaller, more restricted market. Uncertainty, redirection of focus, reorganization and cost cutting are presently main themes in the industry and weigh heavily on equity prices. Valuations are extremely low but the long term outlook is favorable because of the continuing ageing of the population and increasing demand for health services. We think this is a historic chance to participate in an attractive industry. Our favorites are Johnson & Johnson, Glaxo, Medtronic, Synthes and Zimmer.

Conglomerates are another long term favorite of ours, although this business form is presently not being favored by academia or analysts. Well known examples are Berkshire Hathaway, Pargesa and Cheung Kong. They are not focused; often they even lack significant synergies between different sectors. However, diversification tends to reduce risks and base them more broadly. Thanks to this stability they are well suited to form the foundation of a personal portfolio. With all three of them we have had good results over the years, although they also had periods of underperformance. Obviously the star has been Berkshire. Despite his age Buffett is riding high at the moment. In years past, while being criticized as inactive and tied to the old economy, he has accumulated one of the biggest cash hoards of any company. Now, with a recession looming and stock prices on the retreat, he is an active, selective acquirer, while his counterparts in banks and finance companies are badly squeezed and under pressure to find cash due to huge write downs and losses. Stock price performance has been stellar in 2007. Berkshire has now the third or fourth highest valuation among all US stocks with over \$200 billion. Paul Frère of Pargesa and Li Ka-shing of Cheung Kong have also been outstanding performers and are still very active at age 81 and 79 respectively.

In the past few years small and medium sized firms have outperformed their larger brethren. Many Blue Chip companies have stagnated in price since the year 2000 and are being neglected, despite the fact that their earnings and dividends have grown continuously. We find that they trade now at very attractive valuations. In tough times their solid finances and strong market positions should favor them over their smaller competitors. We think they have a fair chance to improve their relative performance. Among others, our favorites are GE, Home Depot, American Express, Walmart, Carrefour und Reed Elsevier.

At the beginning of a new year we are in the midst of a financial crisis and there is ample uncertainty. Expectations are subdued; a recession is a distinct possibility. However the year may turn out to be more positive than it appears now. Some valuations are very low, while dividend yields are attractive and profitability is still very satisfactory. We want to bear with our mentors Buffett & Co., namely to be now less pessimistic than the crowd and to add to positions at lower prices.